MEMORANDUM

To: District Examination and Supervisory Staff
From: George A. Reynolds
Deputy Commissioner for Supervision
Date: May 15, 2003
Re: Assessing Liquidity in Community Financial Institutions.

BACKGROUND

The Department has noted over the past several years that there has been a steady and significant decline in the levels of core liquidity being maintained by community banks. There are a number of factors contributing to this decline, the most significant of which are the intense margin pressures that have been brought to bear against banks and material changes in the sources of bank funding, with greater amounts of short and medium-term borrowing being used to fund bank operations. These trends have combined to push liquidity to levels that are far below historical levels of liquidity.

For the most part, financial institutions have been able to reduce liquidity levels without experiencing undue safety and soundness problems but the question remains: what level of minimum core liquidity needs to be maintained in a bank to insure that liquidity does not present a safety and soundness concern and what should be the policy of the Department is dealing with banks that drop below such a level?

Historically, the approach of the Department has been to establish a fixed threshold and state that any bank that fell below this threshold was to be criticized and placed on a program of liquidity enhancement. Such an approach is not realistic in the current liquidity environment where a financial institution may have ready access to secondary sources of liquidity, may have cyclical liquidity demands that increase or decrease at different times of the year and which may have improved monitoring and management procedures to manage their liquidity at lower levels.

In spite of such mitigating issues, the Department has observed that there are certain levels of core liquidity, below which a bank may begin to experience problems in meeting its day to day liquidity requirements including cash letter requirements, deposit withdrawals and lending requests. It has been the observation of the Department that when core liquidity drops below 10%, such problems may become more prevalent if secondary sources of liquidity are not available to provide liquidity support. While this level of liquidity is not considered to be a "bright-line" minimum, bank management has a rebuttable presumption to overcome regarding liquidity adequacy when core liquidity drops below this level. We believe that when core liquidity drops below 10%, it is appropriate for the Department to ask management to specifically document their ability to manage liquidity in the following areas:

1. How is the bank monitoring and managing liquidity on a daily basis to make certain that adequate liquidity is being maintained to meet short-term liquidity requirements?

2. How well is the bank meeting the internal liquidity guidelines and limits established in the written Liquidity Policy of the Bank?

3. What liquidity requirements (deposit maturities, loan commitments, etc.) are needed immediately and what requirements are expected over the next 30 days and how would the bank deal with a large, unexpected liquidity requirement should one arise in the course of business?

4. What sources of secondary liquidity could be utilized to meet liquidity demands and what measures have been taken to assure that these sources can be readily drawn upon on short notice? How significant is the need for secondary liquidity, what is the cost of such liquidity and how long will these extra expenses impact the bank? Does this present any safety and soundness risk to the bank or can the financial and operating structure of the bank absorb these costs?

5. What is the deposit structure of the bank? What percentage of deposits represents core deposits and what percentage of deposits is represented by large denomination certificates of deposit, out-of-territory deposits or deposits raised through deposit brokers or the internet? While the use of these deposit sources within a diversified funding strategy is appropriate, it should be recognized that some of these deposit sources are more volatile and subject to fluctuations based on rates, issues related to reputation or legal risk and other external factors.

6. Are there any safety and soundness factors that could impact the ability of the bank to utilize non-core sources of the funding in the bank? How is the bank assessing asset quality, capital adequacy and other factors that could impact on the bank's ability to draw on secondary sources of liquidity?

7. Do agreements with providers of secondary sources of liquidity include covenants such as minimum acceptable levels for regulatory capital, maximum levels of classified assets or earnings thresholds?

8. To what extent do loan portfolios conform to securitization requirements and could they be readily sold in the secondary market as a source of liquidity? Also to what extent has the bank established a "pipeline" of loans that are regularly sold in the secondary market?

9. Does the bank have adequate policies and procedures regarding asset/liability management? Is there an active and functioning asset/liability management committee and an effective management reporting system in this area?

10. How is liquidity being reported to the Board of Directors of the Bank, or holding company?

CORE LIQUIDITY

What constitutes core liquidity for the purposes of the above analysis? Core liquidity represents cash and all assets that are readily convertible to cash on an immediate basis. The amount of these liquid assets divided by the deposit liabilities of the bank, short-term borrowings and other non-depository sources of funding which are due within one year equals the liquidity ratio. A question that often arises concerns loans on the bank's books and whether or not they represent a source of liquidity. Our view is that unless these loans are in the "pipeline" and immediately and readily available to be sold at that moment, then these loans are not core liquidity, although they are certainly a source of secondary liquidity. Likewise, lines of credit with correspondent banks, Bankers Bank, FHLB or the Federal Reserve, while valuable and needed by a bank, are not core liquidity (See comment below regarding preplaced securities). If a bank develops safety and soundness problems and is excessively reliant upon such sources, they may find that some of these sources may not be readily accessible, particularly if the overall condition of the bank deteriorates to below a CAMELS Composite "3" rating.

WHAT SHOULD BE REFLECTED IN THE EXAMINATION REPORT

The intent of these guidelines is not to create a hard and fast numerical threshold, below which banks are considered to be liquidity problems. If liquidity falls below this core liquidity threshold it is incumbent upon the bank to document that that they are properly managing liquidity, that it does not represent a safety and soundness problem to the bank at the current level and that they have procedures in place to meet anticipated and unanticipated liquidity requirements. Banks that fail to meet their own established policy guidelines should expect to be criticized in the examination report for this failure. Banks may exceed the 10% Core Liquidity discussed above, but may have policy and procedure weaknesses, safety and soundness issues, lack of adequate secondary sources of liquidity or other factors that could cause an examiner to downgrade this component.

Some other factors to consider in the report analysis include:

1. Whether the liquidity decline is seasonal, and if short-term measures have been taken to mitigate this seasonal liquidity decline;

2. Whether liquidity is managed at the holding company level and whether adequate liquidity is being maintained systemically to provide adequate support at a bank subsidiary;

3. Whether there are safety and soundness issues impacting liquidity adequacy (Asset Quality, Capital adequacy, earnings performance).

Bank ratings for liquidity should continue to be based on the overall liquidity position of the bank, taking into consideration all the factors discussed above, and should not be based strictly upon the core liquidity measurement. Banks that are rated less than satisfactory should expect **significantly higher regulatory expectations regarding the acceptable level of minimum liquidity** in a Bank. This may have a further adverse impact upon earnings in a bank that is already experiencing negative earnings trends due to higher levels of loan loss provisions and operating expenses.

DIFFERENCES NOTED BETWEEN SUPERVISORY LIQUIDITY AND BANK REPORTING LIQUIDITY

It is frequently noted that the liquidity being reported in the exception reports is substantially different from liquidity being reported in the bank. Often this is due to "over pledging" securities in the bank. If securities are noted to be over-pledged, the examiner should normally recommend that these securities be reviewed and updated so that they are not over pledged, unless this represents a deliberate liquidity management strategy for the bank. Be aware that certain banks, particularly larger banks may be preplacing pledged securities in order to immediately be able to access a secured FHLB or FRB borrowing line. This is an entirely proper strategy if this is a deliberate and reasonable liquidity management strategy in the Bank. This should be distinguished from over pledging due to inattention and lack of proper liquidity management.

Also it has been noted that some banks have a liberal definition of liquidity, including certain categories of loans, in their calculation of core liquidity. See my comments above regarding the use of loans in calculating liquidity. We have even determined that some banks have been using borrowings and other secondary liquidity sources in their liquidity calculations. While these are a source of secondary liquidity, the Department does not consider these to be a part of core liquidity, as discussed above.

LIQUIDITY REPORTING

It is the responsibility of the Supervisory Manager, with appropriate input from District Directors, to determine which banks need to be placed on liquidity reporting. It may be necessary to confirm that the liquidity threshold is not due to misreporting or over pledging, as discussed above. The frequency of this reporting can vary depending on the severity of the situation.